THE CHARACTERISTICS OF THE ASIAN FINANCIAL CRISIS

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1. INTRODUCTION

If this paper had a sub-title it would be 'the Asian financial crisis after one year'.[1] The beginning of the Asian financial crisis is usually taken as the decision of the Bank of Thailand on July 4, 1997 to cease its defence of the baht and to allow the currency to float freely. This decision, which came unexpectedly and as a shock to many market participants, was both the beginning of a classic financial crisis in Thailand and the onset of contagion which saw the financial crisis extend throughout Asia, having serious effects on South Korea, Indonesia, the Philippines and Malaysia. The remainder of 1997 and early 1998 saw a general fall in asset prices and financial distress and the extension of financial support by the International Monetary Fund (IMF) to Thailand, South Korea, Indonesia and the Philippines. In 1998, the effects of the financial crisis spread to the real sector in these and other economies evidenced through reduced industrial production, income, employment and economic activity. Although the initial official responses to the financial crisis were to play down the potential seriousness of the crisis, and were to project a rapid recovery from the crisis, it soon became clear that there was an economic problem and that denial was not a useful policy stance.

In July 1998, the position is that economic growth has been seriously reduced throughout Asia and that a number of economics including Japan, Thailand, South Korea, Indonesia, Malaysia, Hong Kong and Singapore are now in recession although Thailand, South Korea, Indonesia are much more seriously affected. The economic problems of Japan are of longer standing, being a failure to resolve the bursting of the bubble in stock prices and land prices in the late 1980s. The resolution of these problems, which requires working out of the bad debts in the

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1 Earlier versions of some aspects of this paper were presented at two seminars. The first was "The Asian Financial Crisis and the Rural Sector", United Graziers Association (South East Queensland Division), Toowoomba, December 1997. The second was "The Asian Financial Crisis: The Role of Financial Markets", Department of Economics, University of Queensland, May 1998.

banking system and a restructuring of the financial sector, will have important effects in the solution of the 1997 financial crisis. Looming in the background are the potential difficulties of the financial sector in China where slowing of economic growth and a devaluation of the currency would place further pressure on other Asian economies. However the analysis in this paper takes the economic outlook in and economic policies of the USA, Japan and China as given; deterioration in any of these will make recovery from the Asian financial crisis more difficult and protracted. While there are many issues relating to the role of the official agencies such as the IMF to be considered, they are not analysed here.

In July 1998, the important questions to be answered are:

- what were the causes of the Asian financial crisis?
- what are the observable characteristics of the crisis in the first year?
- has the crisis reached the trough?
- what are the prospects for recovery from the crisis and for a renewal of economic growth?
- what are some of the lessons to be learned from the crisis?

2. CAUSES OF THE ASIAN FINANCIAL CRISIS

Without wishing to discuss the causes of the crisis in extensive detail, the Asian financial crisis is taken to be a classic monetary and financial crisis. Financial crisis and associated bubbles have been features of capitalist economies since at least the 17th century. The path of capitalist economic development like that of true love does not run smooth. The most severe financial crisis in the 20th century was the Great Depression of the 1930s which followed the bursting of the stock market bubble in Wall Street in 1929 and which saw a serious dislocation in economic activity in many economies. In the USA, the contraction of economic activity from peak to trough was of the order of 25 per cent; in Australia, the contraction was even more serious as the unemployment rate in the 1930s is estimated to have exceeded 30%. Financial crises have occurred in the USA and Australia since the 1930s but have been less severe, giving rise to Raymond Goldsmith's dictum that mature economies in resolving financial crises create institutional arrangements which ameliorate later adverse economic shocks.

The nature of a classic financial crisis has the following attributes:

1. the crisis occurs after a period of sustained real sector, particularly capital formation and growth;
2. real sector growth before the crisis has substantial speculative elements which can be described as a "bubble" in asset prices;
3. a bubble is a positive deviation from fundamental values or prices;
4. the beginning of the crisis is sparked by some external shock or change in policy;
5. the crisis is defined by a sharp fall in asset prices;
6. the fall in asset prices causes a sharp deterioration in balance sheet positions which invokes a general loss of confidence, an increased demand for liquidity and an attempt to reduce debt;

7. these factors result in liquidity and solvency problems for banks and other financial institutions;
8. in the worst case, there may be a widespread failure of financial institutions and a flight from money;
9. these adverse financial effects result in a reduction of economic activity described as a recession or depression depending on the severity of the fall;
10. recovery occurs through the elimination of bad debts and the strengthening of the economy's financial position and restoration of confidence.

The Asian economies had experienced sustained and substantial growth over a period of at least two decades which had transformed backward economies to affluent and modern societies. This growth was fuelled by input growth, that is by using more labour and capital which was achieved by drawing labour from the rural sector to industrial occupations, by increases in literacy and basic education and by capital equipment financed by high domestic savings. As has been seen from the experience of the former USSR and Japan in the 1950s and 1960s, growth based on a massive increase in inputs has a natural limit. However, this by itself is not enough to explain a financial crisis; all it can do is explain a slowing down of growth rates as diminishing returns and diseconomies of scale set in. In recent years, the Asian economies had an increasingly inefficient investment process; more and more capital assets were used to create over-capacity and grandiose projects which failed to produce an economic return to meet the economic costs incurred in their construction. In addition, investment in social overhead infrastructure was skimped and environment considerations were largely ignored. Among the inefficient capital formation can be numbered

1. over investment by the Korean *chaebol* in computer chips, motor vehicles, steel and ship building
2. CBD commercial property development in Thailand
3. the National Car project in Indonesia
4. the world's tallest building, the linear city and the new international airport in Malaysia
5. the new international airport in Hong Kong.

These misallocations were possible because of government direction of investment and capital funding, corruption and crony capitalism and undeveloped capital markets.

The lack of social infrastructure is evident in the congestion and pollution of major Asian cities and the lack of amenities which promote other efficiencies (while Malaysia has the major edifices referred to above, suburbs of Kuala Lumpur do not have domestic piped water). Indonesia was the prime case of environmental vandalism through logging and burning of forests. The forest fires in Indonesia in 1997 generated substantial costs for itself and neighbouring countries as the smoke and haze created health problems and dangers to airline operations.

Despite the high savings rates in Asian countries, the recent experience has been to finance domestic investment by borrowing from foreign banks. The external debt of the economies has increased to levels which raised questions about their sustainability. Significant speculation emerged in these economies through the financing of long positions in domestic assets through short-term unhedged foreign currency loans. This position was sustainable only so long as fixed exchange rates were maintained, together with foreign confidence in the ability to repay debt and by implicit government guarantees of the banking system.

The beginnings of the crisis was the decision of the Bank of Thailand to float the baht after several attempts to defend it against speculative attacks. The defence of the baht had involved a strategy of

1. active intervention in the spot and forward foreign exchange market;
2. increasing domestic interest rates;
3. instituting formal and informal exchange and capital controls to segment the Thai foreign market into "onshore" and "offshore" markets with the intention of squeezing foreign speculators.

While this policy was successful in stabilising the baht over an extended period and repelling the heavy speculative attack by hedge funds in May 1997, the real weakness in the economy remained uncorrected; the defence of the baht by these policy measures could not be sustained indefinitely. By July 1997, the foreign exchange reserves of the Bank of Thailand had fallen to the minimum level required by law to back the domestic money supply.

The high level of domestic interest rates in Thailand had encouraged local corporations to borrow abroad at much lower interest rates to finance speculative activity in real estate. These loans were unhedged because of the widespread and entrenched belief that the exchange rate would remain fixed. (Later it has been suggested that the resolve of the Bank of Thailand to defend the baht was strengthened by the knowledge that foreign borrowings were unhedged.) Once the baht was allowed to float, the situation changed rapidly; the baht depreciated as Thai corporations sought to buy foreign exchange and foreign investors reviewed their valuations of Thai assets and the baht. In consequence, the exchange rate plummeted.

The fall in the value of the baht was the trigger for contagion as foreign investors tested the value of other Asian currencies in foreign exchange markets. In Korea, there had been concerns about the economy and the high levels of short-term foreign debt; in Indonesia as well, short-term foreign borrowings were high while in Malaysia there was concern about the bad debts of local banks. In the next few months, exchange rates and stock market prices fell sharply and the ensuring examination of the financial and corporate sectors of these economies lead to a substantially downward reappraisal of the fundamental values of assets in these economies.

3. THE EFFECTS AFTER THE FIRST YEAR

The effects will be discussed in terms of exchange rates, asset prices, interest rates, credit ratings and the real economy.

3.1 Exchange rates

The change in exchange rates for nine Asian economies over the year to July 4, 1998 is indicated in Table 1.

TABLE 1

EXCHANGE RATES, CURRENCY UNITS PER USD, JULY 4, 1997 TO JULY 4, 1998

Country	July 4, 1998	One year earlier
China	8.28	8.29
Hong Kong	7.75	7.75
Indonesia	14550.0	2434.5
Malaysia	42.49	35.78
Philippines	41.40	26.40
Singapore	1.70	1.43
South Korea	1368.00	888.00
Taiwan	34.36	27.85
Thailand	42.10	27.75

Source: Data Stream International.

China and Hong Kong have maintained fixed exchange rates; Hong Kong has a currency board system which in addition to keeping a fixed exchange rate has 100 per cent foreign exchange backing for the domestic currency issue. All other exchange rates have fallen but the greatest falls have been in those of the economies which have obtained IMF support programmes, Thailand, South Korea, the Philippines and Indonesia. Indonesia has clearly experienced the most severe fall and the reasons for this marked impact on the Indonesian economy will be explained later in the paper.

3.2 Asset prices

Other asset prices fell. While statistics on real estate prices are not readily available, reports are that these have fallen throughout the region. The change in stock market prices over the year is indicated in Table 2.

TABLE 2

STOCK MARKET CHANGES, JULY 4, 1997 TO JULY 4, 1998

Country	Change on year in local currency (%)	Change on year in USD terms (%)
China	12.8	12.9
Hong Kong	41.7	-41.7
Indonesia	36.1	-89.3
Malaysia	55.9	-73.4
Philippines	32.9	-57.2
Singapore	42.9	-52.0
South Korea	59.9	-74.0
Taiwan	13.1	NA
Thailand	51.1	-67.8

Source: Data Stream International.

In Table 2, the second column indicates changes in local currency terms and the third column changes in stock market prices in USD terms; the third column incorporates the decline in the exchange rate for each country. The change in foreign currency terms, the third column, is the relevant change for foreign investors. Again this table indicates that the effect is not the same for each country and is most marked for the group of economies with IMF programmes.

3.3 Interest rates

The converse of the fall in asset prices is the rise in interest rates; the change over the year is shown in Table 3 below.

TABLE 3

MONEY MARKET AND SHORT TERM INTEREST RATES, JULY 4, 1997 AND JULY 4, 1998

Country	July 4, 1998	Year earlier
China		
Hong Kong	8.88	6.13
Indonesia	44.00	11.25
Malaysia	11.15	7.42
Philippines	13.95	10.97
Singapore	6.32	3.62
South Korea	19.01	12.44
Taiwan	7.40	7.75
Thailand	22.00	22.00

Source: Data Stream International.

The increase in interest rates is again most marked in the four economies with IMF support. The rise in interest rates reflects

1. a risk premium (the compensation required by lenders to lend in these countries rather than in the USA);
2. the effect of more stringent monetary polices; and
3. continuing attempts to support exchange rates.

3.4 Credit ratings

A credit rating for a sovereign country, a financial institution or a trading corporation is essential to access to international financial markets; many lenders will simply not deal with parties who are not rated and the trust deeds of US and European fund managers prescribe that only securities with a minimum credit rating may be held in the trust portfolio. The major international credit rating companies are Moody's Investor Services and Standard and Poors. The system of credit rating symbols used by these companies is indicated in Table 4.

The alphabetical ratings symbols used by both ratings assign a summary view of the prospects that the rated party will meet its financial obligations on time and in full; parties with impeccable ratings are given the triple A rating (Aaa or AAA).

TABLE 4

SYMBOLS USED BY MAJOR CREDIT RATING AGENCIES

Moody's	Standard and Poors
Aaa	AAA
Aa	AA
A	A
Baa	BBB
Ba	BB
B	B
Caa	CCC
Ca	CC
C	C

Source: Moody's and Standard and Poors.

More risky propositions are indicated by a rating of lower down the alphabet. Both companies use modifiers to these basic ratings; Moody's applies 1,2,3 to indicate variations within a standard rating grade while Standard and Poors uses "+" and "-" for the same purpose. The critical cutoff grade is triple B (Baa or BBB); any rating at this or a superior level is of investment grade being an asset which a prudent investor would consider eligible for inclusion in their portfolio. Ratings below triple B involve decidedly speculative elements and a risk of default.

The general experience has been that for parties rated by both agencies the assigned credit rating is similar but not identical. Although there have been complaints about the performance of the ratings agencies during the Asian financial crisis, the burden of these complaints has been that the agencies have been slow to respond to changes and have followed the market rather than lead market changes. Sovereign credit ratings for the Asian economies at July 20, 1998 are indicated in Table 5.

The ratings by Moody's give a *below investment grade rating* to Indonesia, Korea, the Philippines and Thailand. While Malaysia's long term rating for bonds and notes is above investment grade and its bank deposit rating is on investment grade, Moody's has these on credit watch for a possible downgrading. It was announced on July 24, 1998 that Moody's had cut Malaysia's ratings on bonds and notes, as indicated in Table 5 above, from A2 to Baa2 and for deposit from Baa1 to Baa3.[2] In making the announcements Moody's cited "rapid deterioration in the economy" and "...the expected effects on the banking system and on government finances." In the same announcement, Moody's also cut the long-term deposit ratings of three of the top banks in Malaysia to Baa3.

Moody's has since July 20, 1998 announced a review of Japan's rating.[3] Moody's cited deep structural problems in Japan's economy that had defied

2 The Australian Financial Review Weekend July 25-26, 1998

3 The Australian Financial Review July 24, 1998

TABLE 5

SOVEREIGN CEILING FOR FOREIGN CURRENCY RATINGS, ASIAN ECONOMIES AS AT JULY 20, 1998

Country	Bonds and Notes, Long Term	Bank Deposits, Long Term
China	A3	Baa2
Hong Kong	A3	A3
Indonesia	B3	Ca
Japan	Aaa	Aaa
Korea	Ba1	Caa1
Macau	Baa1	Baa1
Malaysia	A2**	Baa1**
Philippines	Ba1	Ba2
Singapore	Aa1	Aa1
Taiwan	Aa3	Aa3
Thailand	Ba1	B1

Source: Moody's Investor Service.
Note: ** under review for possible downgrade.

conventional policy measures and that Japan's policy makers appeared to lack consensus on how to reform and manage the economy. Market expectations are that there is a high probability that Japan's ratings will be downgraded.

These ratings support the previously expressed view derived from consideration of asset prices and interest rates that the economies most affected by the crises are in the order of the most serious effects: 1. Indonesia; 2. Korea; 3. Thailand; and 4. the Philippines

3.5 The real economy

Recent comparative data of the real sectors of Asian economies is difficult to obtain; however, it is clear from official statements that the following economies have moved into recession: Indonesia; Thailand; Korea; Hong Kong; and Malaysia.

The extent of the decline in real economic activity in these countries will be discussed late in the paper.

4. WHY WAS INDONESIA SO SEVERELY AFFECTED BY THE ASIAN FINANCIAL CRISIS?

As shown, Indonesia has experienced a fall in asset prices greater than all other Asian economies and a greater fall in real GDP. In addition, there were particular factors which impacted severely on Indonesia. The level of foreign denominated debt due for repayment in December 1997 held by the Indonesian private sector was at least the equivalent of USD 70 billion (equivalent to about 30 per cent of pre-crisis GDP). The fall in the value of the rupiah ensured that this could not be repaid on time and in full which is reflected in the credit ratings B3 and Ca of Moody's in July 1998. Unlike Korea and Thailand where the debt was owed by a relatively small number of banks, most of the Indonesian debt was owed by private sector trading enterprises estimated to be over 200 in all. By the beginning of 1998, Indonesian borrowers were in default and there were serious difficulties in coming to an agreement about rescheduling the debt.[4] In June 1998, an agreement between Indonesia and the Bank Steering Committee reached an agreement on interbank debt, trade credit and corporate debt.[5]

The agreement involved a rescheduling of debt and a reduction in the amout to be repaid involving a delay in repayments over the next two years and full repayment of the agreed amount three years after that. In effect, the indebted corporations, said to be the vast majority of companies listed on the Jakarta Stock Exchange, were insolvent and candidates for bankruptcy. However, under Indonesian law there is no enforceable bankruptcy law[6] so that there are no defined property rights in bankruptcy. Moreover, the expectation was that unless foreign investors were cronies of the ruling Suharto junta they would not receive anything in bankruptcy. A rational expectation valuation of the foreign-owned interests in Indonesian corporations was zero. This gave an incentive to dispose of these interests as soon as possible for any positive price. Rationality requires sale to be made immediately to be able to quit the economy and move on to other more potentially profitable activities in other countries particularly as in 1998 the political situation had deteriorated seriously culminating in a popular movement which removed the government from office and in violent civil unrest in which

4 The Indonesian government announced its temporary freeze on foreign debt servicing on January 12. European and Asian bankers fresh from private talks with Indonesian debtors warned that anyone expecting a series of smooth roll-overs of short-term debts would be disappointed. Some banks involved are holding their individual talks, reflecting a vast array of debts and firms which prevent a smooth South Korean-style solution. Official Indonesian sources stated that new bankruptcy laws are being drafted (The South China Morning Post February 9, 1998).

5 "IMF Management Strongly Welcomes Indonesian Debt Agreements", IMF News Brief No. 98/17, June 4, 1998.

6 "Indonesia yesterday estimated the country's foreign debt at USD 137.4 billion and announced it was drafting a new bankruptcy law to deal with the nation's private debt. "Companies not able to solve their debt problems ... must have a legal solution. The government will produce as soon as possible a bankruptcy law," said the Council for Economic and Financial Resilience set up to deal with the debt crisis. The International Finance Corporation and a number of other banks had provided 42 Indonesian companies with USD 1 billion in credit to help them pay off their loans."

The Council headed by Radius Prawiro said there would be no guarantee, bailout or government subsidy of any kind in assisting with privately held debt. Existing bankruptcy processes in Indonesia are time consuming and complex, leaving creditors empty handed after years of chasing debts. The lack of a clear bankruptcy law has further eroded investor confidence in recent months after the spiralling rupiah made many Indonesian companies technically bankrupt (The South China Morning Post February 7, 1998).

widespread looting, distruction of property and violence towards Sino-Indonesians took place. The unrest promoted a capital flight by Indonesian citizens and the political turmoil created further uncertainty about values of assets in the future so that the combined effects saw the creation of excess supply of Indonesian financial assets in asset markets and an excess supply of rupiah in the foreign exchange market. Under these circumstances there is no party available to take the other side of the transaction (no buyers) so there is no limit to the decline in asset prices and the exchange rate.

These views reinforced by "currency board debate" in which the Indonesian government proposed to create a currency board similiar in principle to that of Hong Kong where the local currency would be backed 100 per cent by foreign exchange reserves. The proposal envisaged an exchange rate of 5000 rupiah to the USD but was correctly seen as a blatant and crude attempt to ensure that existing foreign exchange reserves would be appropriated by the members of the President's family and their cronies leading to a much worse position and no chance of stabilising the rupiah. The fundamental criticism of the currency board proposal was that Indonesia did not have and had little chance to acquire the foreign currency required to back the local currency. A supporter of the currency board proposal recognised the short-term criticisms but argued that the currency board was the appropriate long-term solution.

The default of Indonesian corporations and their bankruptcy has a number of effects on the Indonesian economy. The first and most serious is that foreign counterparty banks will not open Indonesian letters of credit which are a basic feature of international trade. The IMF has noted the main elements of the Indonesian program are "Accelerated arrangements to develop a framework with foreign creditors to restore trade finance and to resolve the issues of corporate debt and interbank credit." Without letter of credit facilities exporters and importers have to make their own arrangements about financing their customers and paying for their purchases. This means that exporters have to bear the risk of default or delayed payment by their customers and importers have to find foreign currency immediately on shipment of their purchases rather than have the usual trade credit of perhaps 90 days. Naturally this has a devastating effect on trade and, coupled with the devaluation of the rupiah, suggests trade will grind to a halt. The consequential effects on the economy will be substantial with reduced production and increased unemployment. Just how far the economy will turn down is impossible to predict but it must be said in all seriousness that the current indications are that there is no sign of a bottom to the fall.

5. OUTLOOK FOR THE ASIAN ECONOMIES

What is the outlook for the second year of the Asian financial crisis to July 1999?

There are three current views:

1. there will be a "V" shaped recession and recovery;
2. there will be a protracted "U" shaped recession before recovery;
3. there will be an "L" shaped recession with no definite sign of recovery by July 1999.

The "V" Scenario: This is obviously the most optimistic of the scenarios and is based on the view that the current recession is only a short sharp correction or interruption to the inevititable long term high growth rates that the Asian economies had posted over the last 20 years. The more up-beat projections of this scenario see the Asian economies restored to positive growth in the 2000 financial year.

The "U" Scenario: This view is more skeptical of the ability of the Asian economies to bounce back from the current setback in the short term and projects a recession of more than one year's duration.

The "L" Scenario: This scenario is the most pessimistic of the three and differs from the first two in two important respects. The first difference is that the "V" scenario sees a much more abrupt and deeper recession; the second is that the timing and extent of the recovery is highly uncertain.

The "V" scenario is favoured by the governments of the Asian economies, by the official agencies particularly the IMF and by commentators and other governments who had been enthusiastic boosters of "the Asian miracle". The response of many commentators and official agencies in Australia to the Asian financial crisis was denial. I won't embarrass those people by citing chapter and verse but you may remember the 1997 pronouncements which said that the crisis was a short-term adjustment that would be over in a few months. This is clearly not so.

We can obtain some clear information that the official agencies and the IMF have systematically understated the decline in economic activity. As part of the IMF support program, countries are required to set out their policy intentions and policy prescriptions in a document entitled "Letters of Intent of the government of "Country", which describes the policies that the "Country" intends to implement in the context of its request for financial support from the IMF."

The IMF program for Thailand has produced three reviews resulting in three letters of intent. The changes in the estimates for 1996, 1997 and projections for 1998 are presented in Table 6.

TABLE 6

CHANGES IN OFFICIAL ESTIMATES OF REAL GDP GROWTH IN THAILAND (PER CENT PER YEAR)

Year	First Letter of Intent November 25, 1997	Third Letter of Intent June 10, 1998
1996	6.4	5.5
1997	2.5	-0.4
1998	3.5	-4.0 to -5.5

Source: Letters of Intent of Government of Thailand; see also Mid Year Economic Review, Bangkok Post, 30 June 1998.

The revisions to the 1996 and 1997 growth figures over a period of six months indicate that that there is a broad confidence limit; the estimate of 1998 growth has changed by 9 percentage points over six months.

TABLE 7

CHANGE IN OFFICIAL REAL GDP PROJECTIONS, KOREA

Source	Projection, 1998 (% per year)
Letter of Intent December 3, 1997	3.0
Letter of Intent May 2, 1998*	-1.0

Source: Letters of Intent of the government of Korea.
Note: The Letter of Intent states "although more negative growth remains possible".

The revision of the Korean growth estimate of 4 percentage points in six months suggests that even the short-term economic forecasting techniques used in this exercise lack precision.

The IMF has systematically underestimated the decline in GDP in Thailand and Korea. On April 2, 1998 the Managing Director of the IMF stated: "We expect GDP to decline by about 3 per cent in Thailand this year and by 1 per cent in Korea."[7]

It was said above that there is no bottom in sight to the Indonesian recession. The moving projections by the Indonesian authorities and the IMF are reported in Table 8.

TABLE 8

CHANGE IN OFFICIAL REAL GDP PROJECTIONS, INDONESIA

Source	Projection, 1998 (% per year)
Letter of Intent January 15, 1998	0.0
Letter of Intent April 10, 1998	-5.0
Letter of Intent June 24, 1998	more than -10.0

The Letter of Intent of the Indonesian government dated April 10, 1998 stated: "We expect the economy to start to recover in the second half of 1998 and the decline in real GDP is predicted to be 4 per cent for the fiscal year."

We would conclude that the economic projections in the official Letters of Intent are not credible and are designed to sugar coat the pill of the stringent economic measures which must be implemented. *The Economist* magazine cites some economic facts which belie the official forecasts:

1. Indonesian exports declined by more than 70 per cent in April 1988 compared with the same month in 1997;
2. about 20,000 Korean companies have failed this year;
3. car production in Thailand fell 77 per cent in the first five months of 1998.

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[7] Michael Camdessus, "Is the Asian Crisis Over?", Address to the National Press Club, Washington D.C., April 2, 1998.

Private sector forecasts are much more gloomly than the official one; these forecasts according to *The Economist* are for the following declines in real GDP this year: Korea 8 per cent; Thailand 6 per cent; and Indonesia 15 per cent or perhaps even 25 per cent.

Some Thai analysts suggest that the bottom to Thailand's decline may be reached in October 1998 while the Asian regional manager of Moody's has stated that recovery may not take place for anywhere from 3 to 7 years.

The conditions for recovery are stringent; recovery will not occur until the following minimum conditions eventuate:

- persistent surpluses on the current account of the balance of payments allow the repayment of debt and the IMF;
- credit ratings are restored to investment grade;
- reform of the financial sector is established.

None of these will be achieved in 1998. The reform of the financial sector of the Asian economies will under the most optimistic estimates take two years to implement the basic regulatory structure and no country envisages that their banking system will meet the international accepted capital adequacy standards before 2001. On all of these grounds we would reject the optimistic "V" scenario and suggest that the "U" scenario is the more likely for Korea and Thailand, and that positive growth may not be achieved for five years.

Indonesia is a different case entirely. This analysis of the Indonesian economy concludes that it has been hit most severely and that there is no bottom in sight. Indonesia matches the pessimestic "L" scenario.

6. LESSONS FROM THE ASIAN FINANCIAL CRISIS

The lessons of the Asian financial crisis are that, although it can be seen as a classic financial crisis, concentration on the macroeconomic indicators of the past experience of the IMF, provides no good guidance to how well economies are performing. In the 1990s in a global financial environment successful economies are required to have well functioning financial systems, sound corporate governance, open, honest and accountable government, enforceable bankruptcy laws and transparency in economic transactions. The process of economic reform is not a once-and-for-all action; regular evaluation of economic regulatory structure is required.

Alice M. Rivlin, Vice Chair of US Federal Reserve System, has suggested that there are three prescriptions arising from the lessons of the crisis which would, in future, improve economic performance and moderate the effect of financial crises. These are:

1. world's capital markets would function better with more complete, accessable and timely information flows. Improving transparancy should apply not only to business and banks, but to official bodies;
2. the structure, functioning and supervision of financial systems in emerging market countries should be strengthened;
3. private creditors should take on a greater portion of the burden of resolving future international financial crises.

Michael Camdessus, Managing Director of the IMF, has suggested building blocks for a new financial architecture for a globalised world which are:

1. globalization provides countries fully integrating into the world economy the potential for growth and prosperity;
2. universal consensus on importance of an increasingly open and liberal system of capital flows for globalisation to deliver its promises;
3. the golden rule of transparency;
4. good governance;
5. a set of standards and codes of best practice;
6. an option for a multilateral approach to handle problems.

These prescriptions is that they require substantial structural change in many economies and they are unlikely to be realised in the short term.

7. CONCLUSIONS

After one year of the Asian financial crisis, all Asian economies have experienced a decline in asset prices and economic activity. The most seriously affected have been Indonesia, Korea and Thailand. These economies are in default on their foreign debt and their credit ratings have been downgraded to below investment grade. Throughout the region economies have moved into recession and the prospects for an early recovery are regarded as slight.

Three possible recovery paths have been considered (characterised as the V, U and L scenarios). The analysis here rejects the "V" scenario as too optimistic and as implausible but regards the "U" scenario as more probable for Korea and Thailand. The position in Indonesia is more serious and it must be said that there is no foreseeable bottom to the recession. Thus the "L" scenario is considered applicable to Indonesia.

Recovery will not come to the Asian economies until they do the following:

1. generate a surplus on the current account of the balance of payments to repay outstanding debt;
2. sell assets to foreigners to repay foreign debt;
3. restructure their banking systems to international standards of prudence;
4. improve corporate governance;
5. implement workable bankruptcy laws;
6. lift their credit rating to investment grade.